STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

RESPONSE OF AT&T ILLINOIS TO STAFF REQUEST FOR COMMENTS

February 28, 2006

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Q1. Should the Commission's decision(s) concerning whether to investigate rates for competitive telecommunications services differ according to provider types and sizes, service or product types, market conditions, service areas, or other such factors? If so, please explain how the Commission's exercise of its authority should vary across such differing factors and why.

A1. Any decision by the Commission to investigate rates for competitive telecommunications services should not differ by provider type or size, service or product type, market conditions, service areas or other such factors. Under Section 13-502 of the Act, products and services are classified as either competitive or noncompetitive. If the product or service is properly classified, there is no basis for treating some competitive service providers or competitive services as "more" competitive than others. The Commission's objective in overseeing such services should be to allow the marketplace to determine prices to the maximum extent practicable. In the event that the Commission concludes that regulatory intervention is required, any corrective regulatory response should apply to all providers of that service on a provider-neutral, technology-neutral and competitively-neutral basis.

Q2. Should the Commission require that carriers submit information (e.g., cost studies) to assist it in determining whether to open an investigation into the justness and reasonableness of rates for competitive telecommunications services? If not, please explain.

If yes, please address (at a minimum) the following in your answer:

a) The source of the Commission's authority to require such information.
b) A list of such potential information, the purpose of each item, and the circumstances under which the item should be provided.
c) An assessment of whether, and if so why, tariff filings that exceed certain thresholds require more detailed explanations and backup than tariff filings that do not exceed these thresholds? If yes, please provide examples of appropriate thresholds and the additional information that should be required with such a filing.
d) An assessment of whether the Commission should specifically impose on carriers proposing rate changes a requirement that the carrier provide *prima facie* evidence that the proposed changes yield just and reasonable rates?
e) An assessment of whether the Commission should require carriers to file annual demand, rate and/or other data related to their provision of competitive services including an explanation of what should be filed and under what circumstances.

A2. The Commission should not require carriers to submit information (e.g., cost studies) to assist it in determining whether to open an investigation into the justness and

reasonableness of competitive rates, unless the Commission has reason to believe that the rates are not at or above LRSIC costs as required by Section 13-502. There is no one source of information that will demonstrate whether rates are too high to be just and reasonable. (See response to Question 3 below). It is costly to perform cost studies and/or prepare other information. It would be contrary to the policy set forth in Section 13-103(b) of the Act that the ". . . burdens of regulation should be reduced to the extent possible . . ." to require the submission of information which is not likely to provide a meaningful basis for evaluating just and reasonable rates. However, if such information were required, it should be done in a competitively neutral manner to avoid burdening one provider, or group of providers, more than another.

(a) The Commission's authority would stem from its general supervisory authority over telecommunications carriers (e.g., Section 5-101), which applies to competitive and noncompetitive services.
(b) AT&T Illinois is not recommending that any such information be required.
(c) AT&T Illinois is not recommending that any such thresholds be established.
(d) AT&T Illinois is not recommending that carriers be required to provide *prima facie* evidence that the proposed rate changes are just and reasonable.
(e) AT&T Illinois is not recommending that the Commission require carriers to file annual demand, rate and/or other data related to their provision of competitive services. Rate data is currently contained in the carriers' filed tariffs. Demand data, standing alone, does not provide useful information relative to the reasonableness of price levels. Demand changes reflect the effects of competition, changing customer preferences, the economy and many other factors.

Q3. Are there any specific factors or circumstances that might automatically "trigger" a Commission Section 9-250 investigation into whether a rate change for a competitive telecommunications service is just and reasonable? If yes, please provide an explanation or justification for each proposed trigger, an analysis of the how such a trigger would be applied, and an explanation of what information would be necessary to apply such a trigger. Examples of factors that might be incorporated into such criteria are:

a) markup over incremental cost;
b) number of competitors providing the service;
c) comparison to rates charged by competitors for similar or identical services;
d) percentage increase over existing rate;
e) complaints;
f) discrimination;
g) reasonableness of profits;
h) markup over fully allocated costs;
i) consistency with other specified statutory and/or public policy goals;

j) the availability of substitute services;
k) elasticity of demand; and
l) industry studies relating to the services in question.

A3. There are no specific factors that should automatically trigger a Commission Section 9-205 investigation into whether a rate change for a competitive telecommunications service is just and reasonable.

a) Mark-up over incremental cost. Under Section 13-502, competitive service rates must meet a cost "floor" test, *i.e.*, they must be equal to or higher than an appropriate measure of incremental cost (e.g., LRSIC). The Commission should initiate an investigation where it has reason to believe that the price change proposed by the carrier will not meet the relevant cost test. The statute does not, however, impose any "ceiling" on competitive service rates or a maximum mark-up over incremental cost.

The Commission should not treat mark-up over incremental cost as a "trigger" as a matter of policy either. Because of the legacy of past regulatory policies, there is a wide range of price-to-cost relationships today for individual local exchange services. For example, AT&T Illinois' residence network access lines are currently priced very close to LRSIC, while other products and services are priced substantially above cost to allow AT&T Illinois to recover its total costs of operations. In addition, the absolute level of cost associated with products and services varies significantly. For example, the LRSICs associated with most central office features are extremely low, producing a nominally "high" mark-up over cost. Particularly where products and services are purchased from the same provider (e.g., access lines and features), the mark-up on individual subproducts and services may not be meaningful.

Even in non-regulated markets, providers routinely recover different levels of contribution (*i.e.*, profit) from different products and services. For example, grocery stores apply very different markups to bread as compared to imported marmalade. General Motors does the same with Chevrolets and Cadillacs. In theory, where a firm in a competitive market incurs shared fixed and common costs across products or services, both supply (i.e., cost) and demand (i.e., market conditions) determine the competitive market price.

b) Number of competitors providing the service. There is no direct correlation between the number of competitors currently providing a service and the competitiveness of the marketplace. As there are no barriers to entry in the telecommunications marketplace, competitiveness cannot be assessed without reference to potential competitors as well as firms currently supplying service. Thus, counting the number of competitors is not well-defined. In addition, in economic theory, there are

circumstances where most benefits of competition can be obtained from only a small number of competitors. Under the strict assumptions of a Bertrand oligopoly, price is driven to incremental cost in a market with only two competitors. Under Cournot assumptions, equilibrium price declines rapidly towards cost as the number of competitors increases. See, e.g., D.W. Carlton and J.M. Perloff, *Modern Industrial Organization,* 2nd edition, Harper Collins, (1994), Appendix 7A.

c) Comparison to rates charged by competitors for similar or identical services. No simple comparison can be made between the rates charged by different competitors for the same product or service. Competitors may have different strategies on how to recover their total costs of operation across the portfolio of products and services they offer. Consumers evaluate these offerings based on the total price they would expect to pay for all services purchased together. Therefore, if one competitor were to charge more for a network access line and less for features and another competitor were to adopt the opposite pricing strategy, both pricing approaches may be just and reasonable. In addition, most competitors in the local exchange service marketplace take into account all revenues they expect from that customer, including long distance revenues, high-speed internet access, voicemail and other products in developing their prices for local service. Finally, newer entrants are likely to price their overall offerings below that of the incumbent to encourage customers to switch providers. This does not render the incumbent's prices unjust or unreasonable nor does it mean that price increases by the incumbent should be viewed as problematic.

d) Percentage increase over existing rate. The percentage increase over the existing rate does not provide meaningful information on the reasonableness of the price. Where prices have been subject to regulatory constraints for a long period of time, relatively large percentage increases may be appropriate to bring them in line with what would have otherwise resulted from competitive market forces. Percentage increases are also unduly impacted by the base price charged for that particular product or service. For example, a $1.00/mo increase on a product that costs $15.00/mo (e.g., an NAL) constitutes a much smaller percentage increase than a $1.00/mo increase on a product that costs $2.50/mo (e.g., a feature). However, the impact on the total bill to the customer who subscribes to both would be the same. Furthermore, the product costing $2.50/mo could have been priced much higher (e.g., $4.00) at an earlier point in time and the rate may have been reduced as a market experiment or due to regulatory requirements. It is debatable whether a price change that does not even reach the initial price for the product constitutes an "increase."

e) Complaints. The mere existence of complaints does not render a rate unjust or unreasonable. Many consumers object to price increases as a matter of course in both regulated and unregulated markets. If consumers object to the new prices, they can take service from an alternative provider or use less of the repriced service.

f) Discrimination. AT&T Illinois assumes that Staff is positing a situation where some, but not all, of a carrier's customers for a particular product or service experience a price increase. AT&T Illinois cannot comment on such a practice in the abstract. However, carriers may face different cost or market conditions relative to some customer groups, or some geographic areas, than others, thus justifying different price levels.

g) Reasonableness of profits. Reasonableness of profits is a rate-of-return concept which should not be applied to competitive services. The marketplace will determine overall profit levels. Also, there is no meaningful way to determine profits on an accounting basis for an individual competitive service or even competitive services as a whole, where joint facilities are used to provide multiple products and services. In that situation (which is common in telecommunications), rate base and expenses would have to be allocated to particular services. Such allocations are not meaningful from an economic perspective and are, therefore, arbitrary and certainly subject to dispute. In any event, AT&T Illinois does not have a model in place that would determine profits on an accounting basis for individual competitive services or competitive services in aggregate.

h) Mark-up over fully allocated costs. See response to g). Such calculations do not provide useful information as to the justness or reasonableness of the rate or what the competitive market level of price could or should be. Prices in these markets are determined by both supply and demand conditions, and cost information alone cannot be used to assess the competitive level of price for individual services.

i) Consistency with other specified statutory and/or public policy goals. This factor is too broad to permit meaningful comment. However, the Commission should be cautious about using general concepts like the "public interest" or "universal service" to second guess the functioning of the competitive marketplace and/or to place constraints on one carrier that are not imposed on all carriers. Any such regulation should be carrier-neutral, technology-neutral and competitively-neutral in both design and effect.

j) The availability of substitute services. Section 13-502 requires that functionally equivalent or substitute services be available as a pre-condition for the competitive classification. Therefore, this is not a relevant factor to assess price changes. It would only be relevant if the Commission were to open an investigation into the classification itself.

k) Elasticity of demand. AT&T Illinois does not know whether Staff is referring to product elasticity or firm elasticity. The most relevant consideration would be firm elasticity (i.e., the willingness of consumers to change providers in the event of a price increase by one provider). See, for example, W.M. Landes and R.A. Posner, "Market Power in Antitrust Cases," *Harvard Law Review* 95:937-96 (1981). AT&T Illinois is not aware of any such firm elasticities for local exchange service. AT&T Illinois is also not aware of any unique characteristics of the local

exchange marketplace that would justify regulatory intervention based on firm elasticities, if they were available. Moreover, the elasticity of demand faced by the firm depends on the prices charged by the firm. When those prices are constrained by regulation, the resulting price elasticities of demand are artifacts of regulation, not inherent characteristics of the market. For example, wireless and broadband services may be a much better substitute for wireline basic exchange service for more customers at a higher wireline price. Customers have already demonstrated their willingness to use alternative providers of telecommunications services when they conclude that alternative providers offer superior products and/or better prices.

l) Industry studies relating to the services in question. AT&T Illinois does not know what Staff intends by this factor.

Q4. Should the Commission investigate (through a Section 9-250 hearing) whether a rate change for a competitive telecommunications service is just and reasonable without previously determining a "just and reasonable" standard appropriate for competitive telecommunications service rates? That is, should the Commission establish criteria in a rulemaking or other "global docket" to determine whether a rate for a competitive telecommunications service is just and reasonable or should the Commission review each tariff on a case by case basis? Please explain.

A4. AT&T Illinois does not recommend that the Commission attempt to determine *a priori* a "just and reasonable" standard appropriate for all competitive service rates. This would have to be determined on a fact-specific and circumstance-specific basis relative to the specific product or service at issue. However, were the Commission to determine that a particular tariff filing by a particular carrier raised "just and reasonable" issues, any ensuing investigation should be conducted in a "global docket" to ensure that all carriers are subject to whatever standards result from that investigation.

Q5. Please explain how the "just and reasonable" concept is most appropriately applied to competitive telecommunications services. Please include the following in your answer:

a) Any case law you believe to be directly pertinent or applicable.

b) A proposed "definition" of just and reasonable - as applied to rates for competitive telecommunications services.

c) A list of criteria that would allow the Commission to determine whether a rate for a competitive telecommunications service is just and reasonable. Please provide an explanation or justification for each proposed criterion, an analysis of the how such criteria would be applied, and an explanation of what information would be necessary to apply such criteria. Examples of factors that might be incorporated into such criteria are:

i) markup over incremental cost;

ii) number of competitors providing the service;

iii) comparison to rates charged by competitors for similar or identical services;

iv) percentage increase over existing rate;
v) complaints;
vi) discrimination;
vii) reasonableness of profits;
viii) markup over fully allocated costs;
ix) consistency with other specified statutory and/or public policy goals;
x) the availability of substitute services;
xi) elasticity of demand; and
xii) industry studies relating to the services in question.

A5.

a) AT&T Illinois is not aware of any Illinois case law that directly addresses how the "just and reasonable" standard should be applied to competitive services.
b) A "just and reasonable" competitive service rate is one that is at or above an appropriate measure of cost, is sustainable and results from competitive market forces.
c) See response to Q3 above.

Q6. Can the Commission rely on market forces to ensure that rates for competitive telecommunications services (as identified and specified by the PUA) are just and reasonable without abrogating its responsibility to review such rates under Section 13-505?

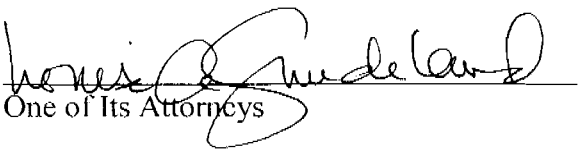
a) If yes, please identify and explain any circumstances required to make this possible.
b) If no, please explain how any such circumstances can be objectively identified and measured.

A6. Yes, the Commission can and should rely on market forces to ensure that competitive service rates are just and reasonable. Section 13-505 provides the Commission with the *authority* to review competitive service price increases in appropriate circumstances, but it does not define such circumstances or *obligate* the Commission to do so. The mere fact of a price increase by one provider does not mean that an investigation is appropriate. Prices routinely increase in all markets, both regulated and non-regulated. In the telecommunications marketplace, price increases may be appropriate for any number of reasons – prices may be too low due to the legacy of regulation; costs may be increasing; the particular carrier may be restructuring its rates in response to competitive pressures and/or economic factors; and so forth. If the price increase is not viable in the marketplace, the carrier will eventually adjust the price because customers will switch to other carriers or reduce their demand for that product or service. This disciplining effect of market forces should substitute for Commission intervention in most circumstances. The Commission can and should limit its investigatory authority to situations where it believes that there has been a significant, structural market failure for that product or service, such that market forces cannot be relied on to ensure reasonable rates from any

provider. For example, the Commission imposed caps on competitive operator services rates for all providers at a time when there was a perceived "locational monopoly" at certain payphones. 83 Ill. Admin. Code Part 770.40. In the event the Commission does take any corrective action, it should apply to all providers in the industry on a provider-neutral, technology-neutral and competitively-neutral basis.

Respectfully submitted,

ILLINOIS BELL TELEPHONE COMPANY



One of Its Attorneys

Louise A. Sunderland
Illinois Bell Telephone Company
225 West Randolph, Floor 25D
Chicago, Illinois 60606
(312) 727-6705